EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2006 and 2007

Spring 2006

About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 under the auspices of the European Commission. The objective of the EFN is to provide a critical analysis of the current economic situation in the euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes four quarterly reports. Further information on the EFN can be obtained from our web site, www.efn.uni-bocconi.it or by e-mail at efn@uni-bocconi.it .

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Highlights

- In spring 2006 the worldwide upswing continues in all main economic regions. Monetary tightening in most industrial countries has little effect, since long-term interest rates are still low and stock market prices have continued to rise.
- In the euro area demand had a weak spot at the end of last year. Investment, however, was still moderately dynamic. Confidence of financial markets and profit prospects of large firms have also improved during the winter.
- The Euro area economy will only gain more momentum if private consumption will recover. Against this stand the long term motives for the relatively high saving rate of private households, in particular old-age provisions in economies with unfavourable demographics. However, slightly improving labour markets will give some dynamics to private consumption. This, in addition to brisk export and investment activity, will result in growth rates which, by standards of the euro area, amount to a healthy upswing.
- Inflation is expected to remain above 2% in the first half of 2006, but there is a 50% probability that it will fall below 2% in the second half, as a result of better medium term perspectives for non-energy industrial goods. The core inflation forecast improves compared to forecasts of previous reports, with the average rate for 2006 at 1.5%. As to key interest rates, an increase to 2.75% can be expected from the ECB for the near future. This bias towards a more restrictive policy is based on the ECB´s concern that the boosting effect of credit expansion on inflation will be stronger than the moderating effects of other factors, such as the output gap.

Table 1 Economic outlook for the Euro area

	2003	2004	2005	2006: 1st half		2006: annual		2007: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
					1.7		1.6		1.5
GDP	0.7	1.8	1.4	2.0	2.4	1.9	2.3	1.9	2.4
					1.4		1.6		2.2
Potential Output	1.8	1.6	1.3	1.5	1.6	1.7	1.8	2.4	2.6
					0.9		0.9		1.4
Private Consumption	1.0	1.4	1.4	1.5	1.9	1.6	2.2	2.2	3.1
					1.3		0.9		1.1
Government Consumption	1.7	1.1	1.3	1.6	2.0	1.3	1.7	1.5	1.9
					2.6		2.2		1.5
Fixed Capital Formation	0.8	1.8	2.2	3.9	5.1	3.6	5.0	3.2	4.9
					6.8		5.9		3.8
Exports	1.2	5.9	3.9	7.9	9.2	7.1	8.3	5.3	6.8
					7.1		6.0		4.1
Imports	3.0	6.2	4.7	8.4	9.7	7.3	8.7	5.9	7.8
					8.0		7.9		7.6
Unemployment Rate	8.7	8.9	8.6	8.1	8.3	8.1	8.2	8.0	8.2
					8.0		7.9		7.3
NAIRU	8.1	8.2	8.3	8.2	8.4	8.1	8.3	7.7	7.9
					2.4		2.5		2.6
Labour Cost Index	3.0	2.5	2.5	2.6	2.7	2.8	3.0	3.0	3.4
					0.8		0.7		0.4
Labour Productivity	0.4	1.1	0.8	1.1	1.4	0.9	1.2	0.8	1.2
					1.9		1.5		1.2
HICP	2.1	2.1	2.2	2.3	2.6	2.1	2.6	1.8	2.4
					2.3		1.5		0.4
IPI	0.3	2.0	1.2	3.1	3.9	2.5	3.5	1.9	3.4

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate and NAIRU that are expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Economic Outlook for 2006

The world economy

In spring 2006 the worldwide upswing continues. World trade has expanded at a healthy pace during the winter, driven by demand from all major economies. Production in the US has overcome disturbances caused by the hurricanes from late last summer. In Japan exports and investment activity are dynamic; they continue to benefit from the high growth dynamics of the South-East Asian countries, in particular from growth in China. Prices for raw materials, and notably for oil, have again strongly risen since autumn, and thus important export countries of these goods are flourishing as well. All in all, the upswing at present is on a much broader base than at its start, when it depended crucially on expansive economic policies in the US.

The monetary policy of the Federal Reserve Board and of the Bank of England are now close to neutral. The ECB has raised interest rates twice last winter, and financial markets expect that further steps will follow this year and next. In March the Bank of Japan announced an end of its policy of quantitative easing; it is expected to begin setting positive interest rates later this year or early next year.

Accordingly, worldwide long-term interest rates have risen somewhat since beginning of this year; but they are still low in nominal and real terms by historical standards. Stock markets continue their upward trend. Thus, costs of capital from external and internal sources are still low. This is an important cause for the upswing to continue, in particular in many emerging markets, where risk premia are on record lows; investors appear to become ever more confident of the soundness of economic policies in these countries.

A decline in the difference between long-term interest rates and short-term ones may, however, signal that financial market participants expect a downturn. This might be the case for the US, where the yield curve is nearly flat, and where the stock market performance during the last twelve months was not as good as in the euro area or Japan. More cautious expectations in the US are well founded: the end of the expansive monetary policy is likely to put an end to the housing boom in the course of this year. As a result, home owners will no longer benefit from capital gains; the household sector will start saving again and private demand will lose momentum in the US.

This report assumes that the price hike of raw materials and oil will level off during this year, adding stability to the world economy. However, stable prices mean that economies which export raw materials to a large degree will be less buoyant than they were recently. Thus, the slowing demand from those countries and – more importantly – from the US in addition with moderately increasing long term interest rates will dampen the worldwide upswing from this summer onwards.

The major risks to this forecast come from a more abrupt weakening of private US demand, and from a renewed oil price hike. Both points are now and for the foreseeable future standard risk factors, given the ever widening current account deficit of the US economy, and given the political liability of important oil producing countries. Furthermore, many oil exporting countries are currently operating at their capacity ceilings, thus any disturbances are now exerting stronger influences on the oil price than in the past.

The euro area

To the good shape of the world economy corresponds a cautiously rising optimism in the euro area, as indicated by the upward trend of most confidence indicators, which started last autumn. This is remarkable given the rather disappointing national accounts data for the euro area for the end of 2006, with declining private consumption and low export growth. While these weak spots are difficult to explain, there are good reasons for the continued moderate upswing of investment: earnings expectations of large corporations were, on average, revised upwards. As mentioned above, financial conditions are still favourable. While these are now very similar all over the euro area, the typical projects of investment differ between the member states: growing world demand for investment goods and an improved competitiveness of German industry have caused its production to rise throughout last year: unit labour costs have been quite stable in the euro area in general, but particularly so in Germany. Hence, capacity utilization has improved and investment in equipment has become more and more attractive. In contrast, in France, Italy and especially Spain, house price booms – in part a consequence of the fallen costs of capital in these countries – make by themselves investment in construction attractive.

This report assumes that the worldwide upswing and low capital costs will still be beneficial during the forecasting horizon, but to a somewhat declining degree. Thus, the euro area economy will only gain momentum if private consumption will recover. Against this stand the long term motives of the – relative to other industrialized countries – quite high saving rate of private households: old-age provisions in economies with unfavourable demographics in particular, but also the fact that during the past couple of years, fiscal policies of many countries, in particular large ones, have lacked sustainability. What nonetheless will give some dynamics to private consumption are slightly improving labour markets: the unemployment rate has been falling all over the last year, by no less than half a percentage point. We expect this trend to continue for this year and next, partly thanks to labour market reforms in some important member states. Increased job security will continue to slowly raise confidence of private households. Already in recent months, consumers have viewed the labour market perspectives and thus the outlook for their financial situation more positively. A revival of private consumption in addition to brisk export and investment activity will result in growth rates which are by standards of the euro area a healthy upswing. A major risk to this forecast is, however, that the positive trend in employment will soon fade out if political resistance puts an end to the necessary process of labour market reforms.

The economic sentiment indicator for the euro area in February showed a 1.2 point increase over January 2006, somewhat greater than forecast but within a 70% confidence interval. This increment slightly improves the new forecasts for this indicator. Except for a small 0.5 point drop in November 2005, the indicator has been growing since June 2005, and the February data confirms the modest recovery that the euro area economy started to register in the second half of 2005. The forecast shows that the indicator – related to the economic growth in the euro area- will continue to recover in the first half of 2006, but that the situation subsequently stabilises (see Figure 1). The performance of the economic sentiment indicator in the euro area is consistent with the GDP growth rate forecast, 1.9% for 2006 and 1.9% for 2007 given in this report.

Figure 1 Euro Area Economic Sentiment Indicator

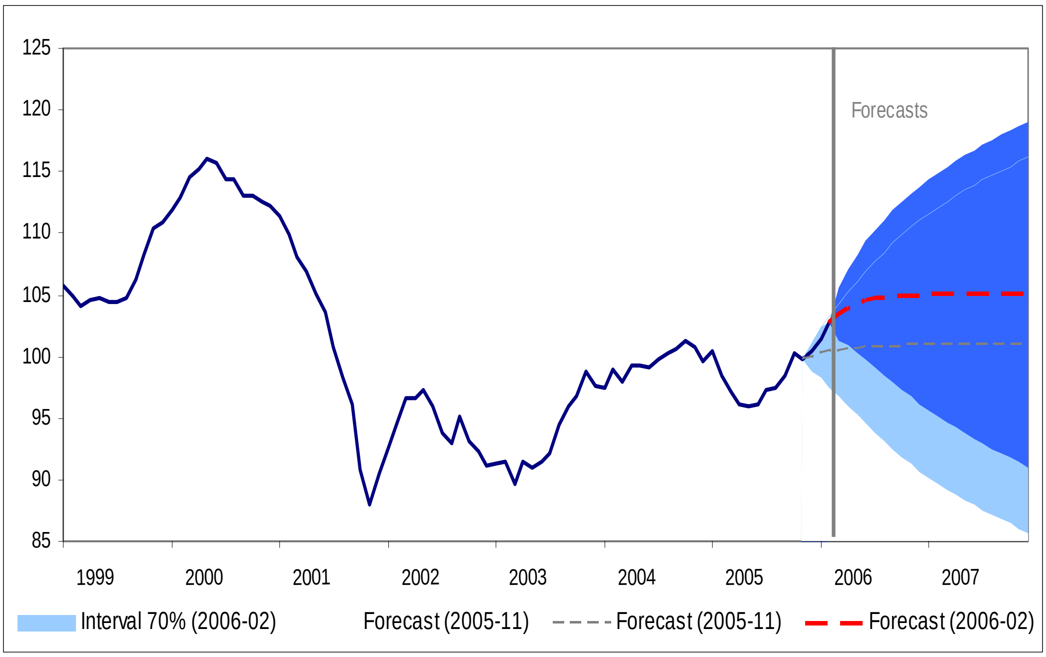
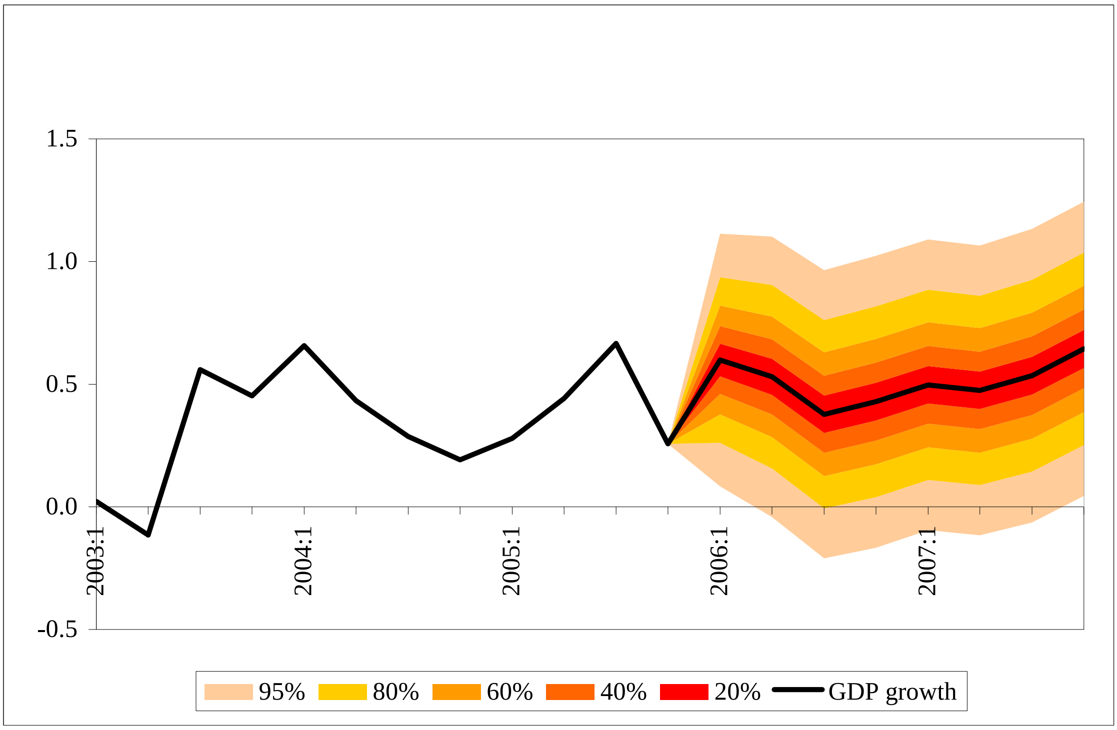
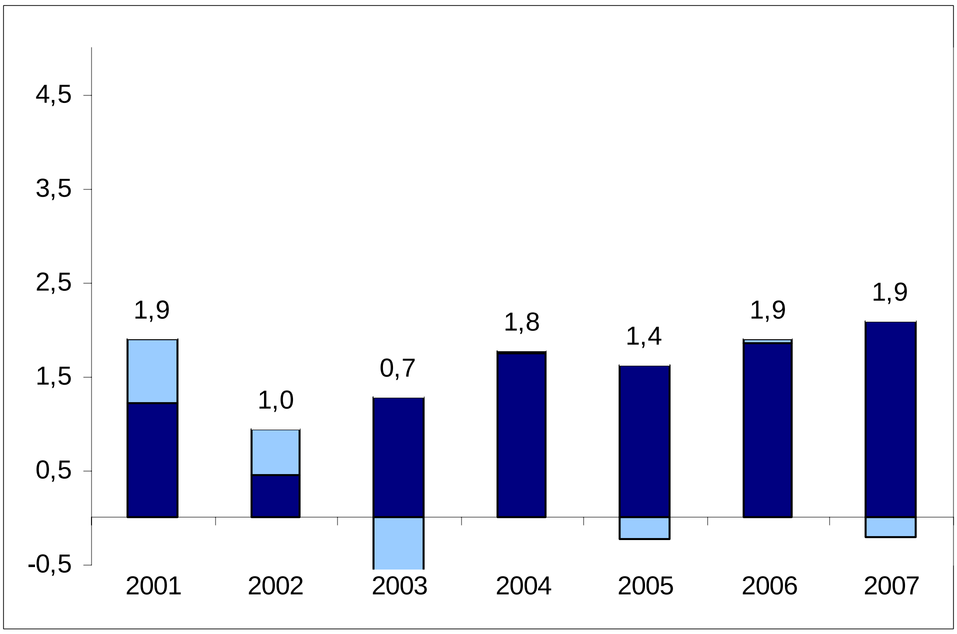


Figure 2 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

Figure 3 Contributions of domestic components and net exports to GDP growth



Domestic demand dark, net exports light area. Percentage points, figures above the columns indicate overall GDP growth

Table 2 Contributions of production sectors in percentage points

Year	GDP growth	Agriculture	Industrial	Construction	Trade Services	Financial Services	Public Services	Net taxes
2001	1.86%	-0.02	0.24	0.07	0.55	0.64	0.35	0.03
2002	0.97%	-0.01	-0.02	0.01	0.22	0.34	0.40	0.02
2003	0.74%	0.00	0.03	0.04	0.11	0.30	0.22	0.12
2004	1.78%	0.14	0.29	0.09	0.36	0.43	0.35	0.12
2005	1.39%	-0.07	0.23	0.09	0.44	0.46	0.18	0.06
2006	1.95%	-0.01	0.42	0.09	0.44	0.59	0.32	0.11
2007	1.94%	0.01	0.42	0.09	0.44	0.59	0.26	0.13

From a supply-side perspective, GDP growth for 2006 is driven by expansion in the industrial sector, while the contribution of the services sectors, as a percentage of the GDP growth rate, will decline from 78% in 2005 to 69% in 2006 (Table 2).

The average annual rates of production growth for different industries classified according to the destination of goods are shown in Table 3. The expectations in the intermediate goods sector have improved with respect to our last report, and we forecast for this sector rates of growth of 3.8 and 1.9% for 2006 and 2007, respectively. All sectors but that of consumer nondurable goods increase their rates of growth in 2006. Consequently, the annual rate of growth of the industrial production will increase from 1.2% in 2005 to 2.5% in 2006.

Table 3 Annual average rates for industrial production in the euro area

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Capital	2.4%	8.2%	1.8%	-1.7%	-0.2%	3.0%	2.5%	3.0%	2.9%
Durable	1.3%	6.2%	-2.1%	-5.5%	-4.6%	-0.1%	-0.9%	1.3%	-0.1%
Intermediate	1.9%	6.3%	-0.7%	-0.1%	0.4%	1.8%	0.8%	3.8%	1.9%
Non Durable	1.1%	0.9%	0.8%	0.7%	0.2%	0.6%	0.8%	0.6%	0.8%
Energy	0.8%	1.9%	1.4%	1.1%	2.9%	2.6%	1.1%	1.8%	1.7%
Total EMU	1.8%	5.3%	0.4%	-0.5%	0.3%	2.0%	1.2%	2.5%	1.9%

The most recent data concerning the euro area economy show that inflation appears to be contained and that previous evidence suggesting that core inflation might increase seems to have disappeared with the January and February figures. Likewise, with regard to activity, the latest economic sentiment indicator does not alter our previous diagnosis of a stabilisation of the recovery experienced in the last six months, and we are forecasting GDP growth rates 1.9% in 2006 and 2007. Finally, the annual growth of the M3 monetary aggregate, as usual in the last few years, is outside the 4.5% reference value, but with an accelerated evolution of household credit, which registered a 9.4% rate in February, partly due to strong mortgage loan expansion.

The figures for inflation and real activity can be interpreted in the sense that there is no urgency for the monetary authority to increase its key interest rates. However, an increase to 2.75% can be expected for the near future. This bias towards a more restrictive policy is based on the ECB´s concern that the boosting effect of credit expansion on inflation will be stronger than the moderating effects of other factors, such as the production gap. Nonetheless, the situation so far does not appear to justify a policy of continuous interest rate rises.

Finally, ECB policy is also based on the belief that the available inflation figures do not provide an upwards biased view of inflation in the euro area. Nevertheless, it does not seem possible to answer this question with a certain degree of certainty, without having quantified the effects of better quality on the products whose prices are used to calculate the HICP. A major project on this subject and on a European scale by Eurostat would appear to be advisable.

With regards to core inflation, our previous reports’ forecasts for a higher rate appear not to have been confirmed (see Figures 4 and 5). Indeed, inflation in the service sector is more moderate and its average annual growth in 2006 is estimated at 2%, two tenths of a percentage point less than last report’s forecast. At the same time, the prices of non-energy industrial goods are evolving with annual growth rates that are clearly lower than our forecasts.

In the euro area, the most inflationist countries for 2006 and 2007 will continue to be Spain, Luxembourg and Portugal and, to a lesser extent, Italy, Ireland and Greece. The least inflationist will be Finland, Germany, France and Austria. Dispersion between countries is expected to gradually decrease in 2006 and 2007. The heterogeneity of the different inflation rates in the euro area is the reason for the large differences between actual real interest rates. Countries with real one-year interest rates significantly greater than 1 pp are Finland, Germany, France, Austria and Netherlands, whereas very low real interest rates can be found in Spain, Italy and Portugal (see Table 4).

Figure 4 Fan chart of core inflation forecasts in the Euro Area

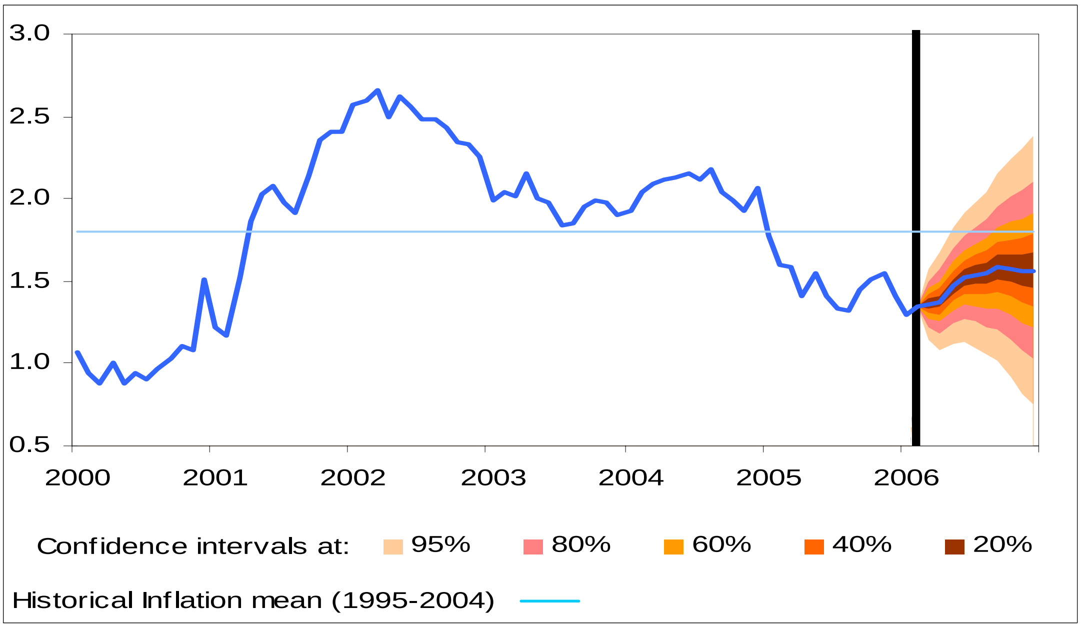


Figure 5 Forecasts for the core inflation in the Euro Area (y-o-y rates)

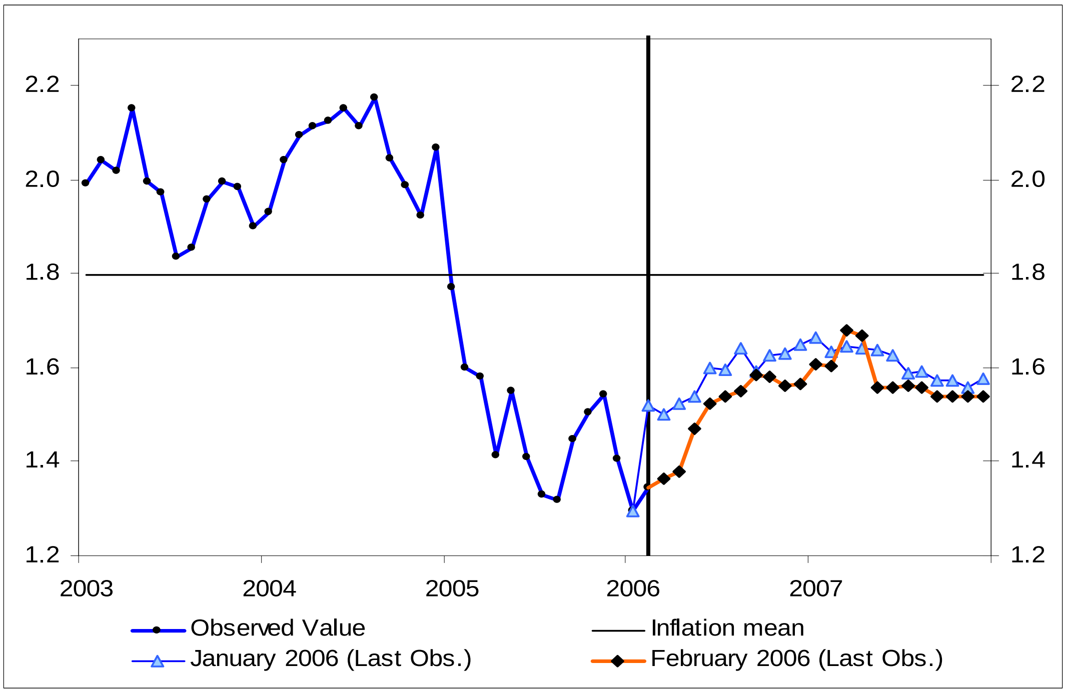


Figure 6 Fan chart of inflation forecasts in the Euro Area (y-o-y rate)

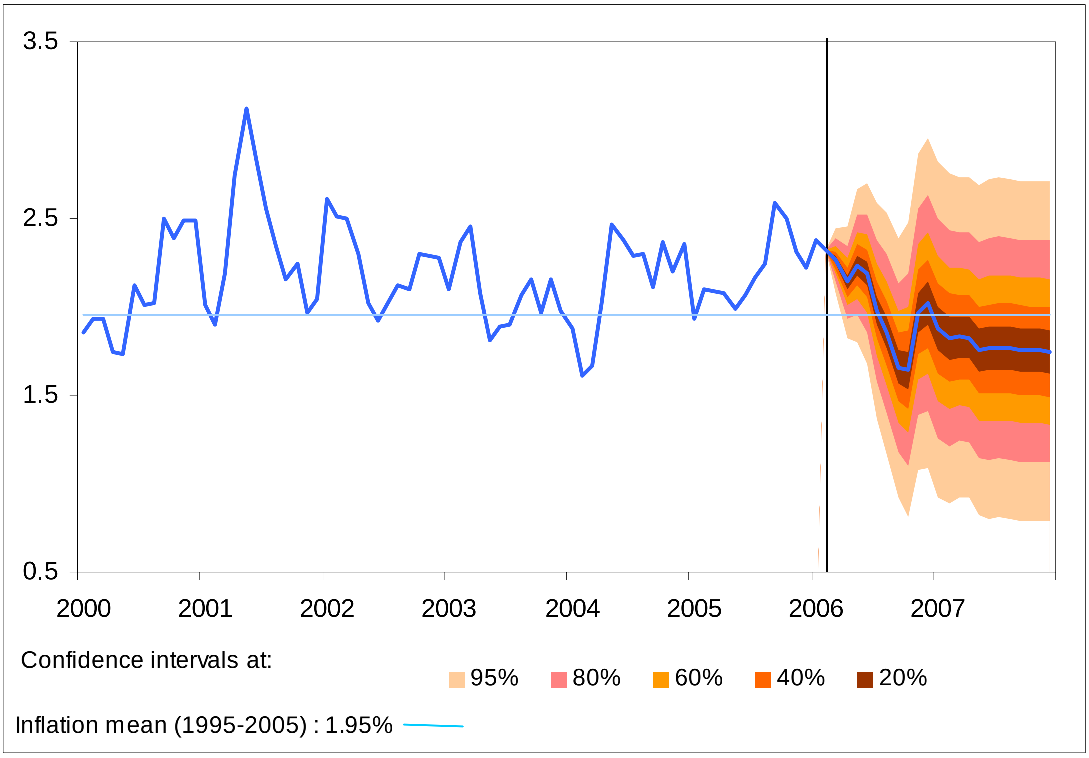


Table 4 Inflation expectations and actual real interest rates

	Inflation expectations		Actual real interest rates	
	Three Months	One Year	Three Months	One Year
Spain	3.16	3.05	-0.46	0.03
Italy	2.61	2.92	0.09	0.16
Portugal	2.96	2.84	-0.25	0.24
Ireland	2.78	2.71	-0.08	0.37
Belgium	2.77	2.59	-0.06	0.50
Greece	2.76	2.56	-0.05	0.52
Luxembourg	2.79	2.56	-0.09	0.53
Netherlands	1.69	1.83	1.02	1.25
Austria	1.68	1.74	1.02	1.35
France	1.65	1.70	1.06	1.38
Germany	1.35	1.28	1.36	1.80
Finland	1.00	1.01	1.70	2.07

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model, described in detail in the EFN Spring 2002 report. Table 5 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics Inc.

The GDP forecasts are quite similar. However, the revival of private consumption is a bit stronger in our forecast, in particular for 2007. This corresponds to our more optimistic forecast for employment.

On inflation, EFN estimates are similar to the forecasts published by other institutions for 2006, except for the OECD forecasts. In almost all cases, slightly lower inflation rates are expected in 2007 than in 2006.

Table 5 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
GDP	1.9	1.9	1.9	2.1	1.8	na	2.1	2	2.1	2.2	2.1	1.8
Priv. Consumption	1.6	2.2	1.4	1.9	1.4	na	1.4	1.3	1.3	1.9	1.5	1.5
Gov. Consumption	1.3	1.5	2	1.5	1.4	na	1.9	1.3	1.8	1.5	1.6	1.4
Fixed Capital Form.	3.6	3.2	3.1	3.2	3	na	3.7	3.4	3.4	3.6	3.5	2.9
Unemployment rate	8.1	8.0	8.5	na	8.4	na	na	na	8.4	8.1	8.2	8.1
HICP	2.1	1.8	2.2	1.8	1.8	na	2.0	2.0	1.6	1.7	2.0	2.0
IP	2.5	1.9	na	na	na	na	na	na	na	na	2.4	2.0

EU: European Commission, European Economy, No. 5, 2005 (Autumn); IMF: World Economic Outlook, September 2005; ECB: ECB Monthly Bulletin, March 2006, OECD: Economic Outlook, No. 78, December 2005; Consensus: Consensus Economics Inc., Consensus Forecasts, March 2006. ECB figures correspond to their macroeconomic projections. Numbers in the Table refer to the mean of the respective projected interval.

Variables of the world economy

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 6 below. For the US, GDP growth will be slowing during the forecasting horizon. Japan is assumed to continue its healthy growth path. Inflation will slow in the US in 2006 and 2007 due to more stable energy prices, while deflation in Japan has come to an end. An oil price of 60 (61) dollar per barrel is expected for the end of 2006 (2007). Rising interest rates in the euro area and the current account deficit in the US will slightly weaken the US dollar relative to the euro. The yen, on the contrary, appreciates: this is in line both with interest rate parities and with the differential between inflation rates; moreover, growth in Japan outpaces that in the euro area.

Table 6 Variables of the world economy

	2006	2007
US GDP Growth Rate	3.3	3.0
US Consumer Price Inflation	2.9	2.3
US Short Term Interest Rate	4.7	4.7
US Long Term Interest Rate	4.8	5.0
Japan GDP Growth Rate	2.3	2.2
Japan Consumer Price Inflation	0.2	0.5
Japan Short Term Interest Rate	0.2	0.6
Japan Long Term Interest Rate	1.8	2.2
World Trade	8.5	6.5
Oil Price	60	61
USD/Euro Exchange Rate	1.22	1.26
100Yen/Euro Exchange Rate	1.38	1.31

Apart from the development of world trade, long term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly taken from Consensus Economics (2006) and OECD (2005). Oil price (end of period) in US dollar per barrel, all other variables in percent.